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Prasetyono, Pipin

Fiscal Policy Agency, Ministry of Finance, Indonesia

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Analyzing non-contributory social pension programs

Pipin Prasetyono

I. Introduction

Old age is one of the stages of life that might bring a person to fall into poverty because of significant declining in capacity. Hence, the growing numbers of old people in the population has created substantial pressure for governments to respond to this issue appropriately, because an inappropriate response might result in an increase in old-age poverty. The World Bank (2017) data shows that there was an increasing trend in population ages of 65 and above, as a percentage of total population in the last three decades, from 5.88 percent in 1985 to 8.27 percent in 2015. Several factors are identified to be responsible for this trend, including higher life expectancy and declining fertility which cause an accelerated demographic transition (World Bank 1994, p. 3; Whiteford & Stanton 2002, p. 44). Hence, a set of social protection programs which are aimed at providing social security benefits for the old-age population is important to ensure that they do not face poverty in their old age.

Furthermore, considering the importance of assisting the old as well as helping the broader economy, the World Bank (1994) suggests three pillars of old age security programs which are non-contributory (basic pension), contributory (forced savings) and voluntary savings (pp. 238-239). Different countries respond to this recommendation differently. For instance, New Zealand and Brunei are among countries which provide a non-contributory, universal basic pension to the elderly, while Australia is currently implementing a non-contributory, selective basic pension accompanied by a mandatory occupational pension, and voluntary superannuation (AFTS 2009, p. 9). Against the above background, and by examining Australia's experience in implementing pension programs, this paper attempts to (1) identify the advantages and disadvantages of non-contributory pension programs, and (2) provide an empirical comparison between universal and mean-tested pension programs. To support the analysis, other countries' experience will also be taken as examples. Considering the role of selective scheme, this paper argues that a non-contributory, means-tested retirement scheme, as has been implemented by Australia, would better support the old-age population by better targeting the beneficiaries, relatively low cost, and enhancing fairness among beneficiaries.

II. Literature Review: overview of Australia's retirement income system

Adopting the World Bank's multi-pillar system, Australia's system is highlighted by two major programs, namely the means-tested Age Pension and the Superannuation Guarantee and a supplement program namely voluntary superannuation (AFTS 2009, pp. 10-13). First, Age Pension is a non-contributory basic pension financed from public revenue and is characterized by means-tested benefits. According to Whiteford and Stanton (2002), means-testing has long been characterizing Australia's age pension even though the change of political regime in 1960s - 1970s has tried to abolish this mechanism (pp. 3-4). The current Age Pension presupposes both income and assets tests to determine the eligibility of those who are 65 years old or over, towards a full or part of the Age Pension benefits.

On the other hand, the Superannuation Guarantee is a mandatory, occupational-based pension program established in 1992 by which employers are required to pay superannuation contributions by a percentage of a worker's ordinary time earnings (Swoboda 2014, p. 4). The basic idea of Superannuation Guarantee is to go beyond alleviating poverty for the retired; it aims a higher standard of living in retirement by a self-provision mechanism (Australian Government 2016, p. 1). Under the Superannuation Guarantee, workers are expected to save more in preparing their pension and hence, decreasing the reliance to the government's support. Currently, applied Superannuation Guarantee charge is 9.5 percent of workers' earnings, which is a significant increase compared to 3 percent when it was introduced in 1992 (Swoboda 2014, p. 25; p. 51). Lastly, there is a supplementary program called voluntary superannuation by which the government provides generous tax concessions to encourage those with saving capacity to voluntarily sacrifice their salary in preparing for their retirement. According to Agnew (2013), the most interesting fact of the voluntary contribution is only about 20 percent of eligible workers participate in this program, and most of them are at the upper end of the income distribution (p. 2).

III. Analysis

1. Advantages and disadvantages of non-contributory pension programs

Non-contributory pension programs could play an important role as an effective income redistribution instrument by which the government enhances the solidarity among citizens. Since a non-contributory program is usually publicly funded by government's general taxes, it would always involve income transfers across income levels because the amount of taxes paid by individuals are different and are based on the level of income earned by them. The redistributive effect of a pension program arises when nobody receives a full equivalence of benefits and contributions they have paid through taxes. According to the World Bank (1994), a non-contributory program entails both intragenerational and intergenerational income redistributions because there are not only transferred income within certain age cohorts of people, but also different age cohorts of people (pp. 131-135). Also, the World Bank stresses the value of solidarity entailed in a non-contributory program in which the high-income earners assist the low-income earners (ibid, p. 234).

In addition, non-contributory pensions, theoretically, would have a wider coverage compared to contribution-related pensions. Non-contributory would be able to mobilize informal sector workers to the formal pension system, especially in developing countries in which informal sector dominates the economic structure. By employing the 2007 data of own-account and contributing family workers as indicators to informality, Bacchetta et al. (2009) reveal that informal workers constitute 49.9 percent of the world's employment, 9.5 percent of developed regions' employment and 59.9 percent of employment in developing countries (p. 26). According to Hu and Stewart (2009), informal workers are characterized by frequently change jobs, have low income that make them difficult to regularly pay the contributions, and have limited knowledge about pension system, thus it as a challenge for them to access a contributory system (p. 2). A non-contributory pension system would simply qualify them as beneficiaries and grant benefits to them once their age exceeds the eligibility age threshold, though further means tests in a selective scheme are needed to determine their eligibility towards the benefits.

However, by relying only on a non-contributory scheme, a social pension program would face the risk of rising costs to be borne by the government budget, which in turn would impact the benefits received by the beneficiaries. In addition, the success and coverage of

non-contributory pensions are highly dependent on the availability of government budget, thus making them vulnerable to be affected by the shock that occurred in the government budget. For instance, a rapid growing of ageing populations would be followed by growing pension costs, which in turn increases the burden to the government budget. Hence, there are two policy options for the government to control the pension costs, which are: (1) reducing the number of beneficiaries, and (2) decreasing the generosity of the benefit (Willmore 2007, p. 35). For instance, the growing elderly population combined with economic deterioration during the 1980s has created pressure for the New Zealand's government budget. As a response, in 1989 New Zealand government decided to decrease the generosity of the pension benefit by decreasing the pension floor, and reduced the beneficiaries by gradually increase the age of retirement from 60 to become 65 in 2001 (Preston 2008, pp. 16-17). Consequently, annual public expenditure on universal pension in respect to GDP significantly decreased from about 8 percent in the 1980s to 5 percent in the late 1990s (ibid).

Furthermore, if a compulsory, contributory pension program is established to reduce the cost pressure of non-contributory pension, this new program could raise additional cost that must be borne by the public through government budget. This additional cost arises due to the government has to provide incentives in the form of, for instance tax concessions, for workers so that they are interested to participate in the new program. Australia's experience shows that the high reliance towards Age Pension has created costs pressure to the government's budget, so the government established Superannuation Guarantee in 1992. To compensate for the postponement of the worker's income until their retirement as well to encourage the working age to work, the Australian government provides tax concessions for both super contributions and entity earnings. Consequently, according to Agnew (2013), a combination of Age Pension and both mandatory and voluntary superannuation has been able to expand the coverage of the pension system as well as to achieve high individual saving rates (pp. 1-3). However, the objective of reducing costs that must be borne by the government budget has not been achieved. Ingles and Stewart (2015) point out that the cost of tax concessions is growing at more than 12 percent per year which is much faster than Age Pension expenditure (p. 18).

In addition, the existence of tax concessions as incentives for the participants of compulsory and voluntary superannuation has caused unfair treatment among participants, in which those with high income will be benefited from higher tax benefit.

The tax benefit is the difference between tax concession rate and normal tax rate that should be paid by workers. For instance, Australian workers who earn more than AU\$180,000 and up to AU\$300,000 per year will be taxed at 15 percent rate for their contribution to superannuation, which is much lower than the normal tax rate including Medicare at 49 percent. Therefore, they would enjoy a 34 percent of tax benefit, and accordingly this benefit must be borne by government's tax expenditure (Rickard 2015). On one hand, this high tax benefit would attract those with high income to sacrifice their income to contribute more in voluntary superannuation, which in turn reduces future pressure towards Age Pension. Yet, on the other hand, this condition would create more pressure to current government's budget since revenue foregone increases as a result of the higher tax concessions that should be provided by the government.

2. The role of universal and selective pension programs

Benefits under non-contributory pension programs are usually granted through two different schemes, which are: (1) universal scheme, regardless to the beneficiary's occupational background, participation to the pension program, income level, or total assets; and (2) selective or means-tested scheme (Euzeby 1989, pp. 12-13). These two schemes have a similar role in regards to the objective of pension programs in alleviating poverty, however in a different manner. According to the World Bank (1994), a universal scheme offers an extending social security coverage, hence, it is possible to prevent poverty by keeping the aged in above the poverty line. On the other hand, a means-tested scheme would enable poverty alleviation objective attained in relatively cheap way, because benefits are provided only for the aged who are below the designated threshold (pp. 239-240).

Universality ensures that all people above a certain age are covered by a minimum income support, hence there is a possibility to gain public support and to enhance solidarity among citizens. Universal scheme offers an opportunity for the governments to design a framework by which their citizens act both as the givers as well as the receivers to the benefit. In contrast to the means-tested scheme which undermines 'potential coalition' among income levels (Gugushvili & Hirsch 2014, p. 5), a universal scheme offers a higher degree of solidarity among income levels, thus it is possible for a universal program to better gain public support. In regards to solidarity, universality represents better solidarity among citizens. According to Gora (2004), social solidarity in a universal pension system

means intergenerational income transfer as the most difficult feature of a pension system could possibly be achieved (pp. 2-4). In addition, social solidarity is an inseparable feature of the welfare state by which a welfare state is possible to implement a universal benefit with full participation from citizens (Zelleke 2016, p. 86).

In addition, the universal pension program would also offer a simpler administration by which it ceases the costly bureaucracies to conduct means tests. At the center of a selective scheme, mean-testing is the administrative method by which the eligibility of beneficiaries is determined. Beyond an administrative method, it is an instrument to distribute benefits to the most entitled beneficiaries, therefore it entails accuracy which in turns lead to a high cost and complex processes (van Oorschot 2002, p. 4). Hence, inaccurate results of means tests could (1) risk the pension benefit to be misdirected to non-eligible beneficiaries, and (2) lead to the incidence of non-take up in which an eligible beneficiary is not registered as the recipient of the pension benefit. Yet, this complex and costly means-testing mechanism would not be necessary in a universal pension program, consequently reduce the administration cost to administer it. According to Willmore (2007), the simplicity of a universal pension lies in the simple mechanism in examining the citizenship requirements or residence requirements as well as designated age to be entitled to the benefit. Though, government's strategies to prevent fraud and corruption would also be necessary (Johnson & Williamson 2006, p. 57). The World Bank (1994) argues that a universal pension scheme would match to the characteristic of developing countries which have limited institutional capacity and relatively weak administrative system (p. 240).

On the other hand, a selective scheme would enable the government to better target the recipients of the pension program. By means-testing, the government could prioritize and determine the beneficiaries namely those who are below the threshold of income or assets tests. Therefore, the pension benefits could be effectively directed to low-income earners or those who are in poverty. Hence, the program's main objective in alleviating poverty could be achieved in a more effective manner. Yet, the other factor which also affects the achievement of the objective of combating old-age poverty is the magnitude of the pension spending itself. For instance, the OECD (2015) reveals a fact that one-third of Australian retirees were living below the poverty line in 2012 (p. 171), even though there is the Age Pension program which is aimed to keep the retirees above the poverty line. This fact could be attributed to the fact that Australia's spending at about 3.5 percent of

GDP on the pension in 2011 was one of the lowest among OECD countries and far below OECD countries' average at 7.9 percent of GDP (ibid, p. 179).

Furthermore, the mean-testing mechanism will allow the government to determine the amount of benefits to be received by the beneficiaries based on the level of income and assets assessed through the means-tested process. Hence, it will enhance a fairness and more equitable distribution of the benefits, because the differences in assets and income will be reflected in the amount of benefits received by the beneficiaries. Under the Australian means-tested Age Pension, singles or couples are entitled to full benefits when their income and assets are below the threshold, yet their benefits would decrease as income and assets increase and becomes zero when their income and assets are above cut off points (DHS 2017a). Consequently, about 50 percent of Australian retirees are entitled to full benefit, about 25 percent of them are entitled to partial benefit and the rest 25 percent receive no benefits since their income or assets exceed the applicable cut of points (Bateman 2013, cited in Agnew 2013, p. 2).

Moreover, the selective pension program would lead to a greater emphasis on the redistributive character of social policy. Directing the benefits to those who in need through means-tested mechanism shows that income is distributed appropriately from high income earners to low income earners. Here the high-income earners are contributors to benefits which will be received by low-income earners. Comparing the Australian means-tested pension program and Sweden's universal pension programs, Stahlberg (2007) shows evidence that the means-tested program involves the higher income redistribution between the rich and the poor (62 percent) compared to the universal program (18 percent) (pp. 209-212).

Lastly, since a means-testing mechanism enables the government to better target the beneficiaries and applying varies benefits for the different assets and income level, it would result in lower cost compared to a universal mechanism, thus enhancing its long term sustainability. According to Agnew (2013), the Australian targeted pension has resulted in relatively low cost compared to other developed countries (p. 3). Yet, several policy changes have to be taken to ensure its sustainability. For instance, the Australian government will increase the qualifying age of Age Pension gradually from 65 to become 67 in 2023, in response to higher life expectancy (DHS 2017b). Moreover, additional policy options regarding the type of benefits granted to the beneficiaries would also

significantly affect the cost of the pension program. For instance, income floor benefits which represent an individual's basic living expenses would be more cost-effective compared to income replacement which is intended to replace individual's living standard during his working lives (Khan 1999, pp. 144-145). As experienced by the Australian Age Pension, means-testing has contributed to 20 percent of cost savings, while the other 80 percent of cost savings is resulted by income floor (ibid).

IV. Conclusion

In conclusion, even though a non-contributory, universal retirement scheme points to higher public support and broader coverage, it would entail a higher cost and is less equitable. On the other hand, a combination between a non-contributory and selective scheme in a pension program accentuates the redistributive role of social protection as well as emphasizes its objective in combating post-retirement poverty. The ability of a non-contributory, selective pension program to effectively direct the benefits to those who at middle-low income through a means-tested scheme, would be essential to maintain its costs low without sacrificing the rate of benefits received by the beneficiaries. Yet, in Australia's case, the efforts to reduce cost pressures towards the means-tested program, by introducing contributory programs which are entitled for tax concessions, have counterbalanced the cost saving, since tax concessions become costly and its cost is faster growing than the costs of the Age Pension. Finally, Australia should continue to implement its means-tested Age Pension especially by considering the advantages of this program in balancing the role of supporting adequate income to the retirees, as well as its potential for long-term sustainability.

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